

## COMMENTS

### DISREGARDING THE CORPORATE ENTITY: CONTRACT CLAIMS

#### I. INTRODUCTION

Limited liability is frequently a primary consideration for adopting the corporate form of business organization. A shareholder or parent corporation invests in the enterprise with the expectation that it will not be liable for the obligations of the corporation. Those doing business with a corporation are ordinarily forewarned that they may look only to the corporation income and assets for security. Occasionally, however, the courts have "drawn aside the veil"<sup>1</sup> in order to impose liability on a shareholder, parent, or affiliated corporation. The purpose of this comment is to analyse the reasons advanced by the courts for disregarding the normal expectations of the parties and to suggest criteria for predicting when the separate identity of the obligor corporation will be ignored.

The apparently responsible corporation's separate existence has been disregarded in many diverse situations,<sup>2</sup> but the reasons usually advanced by the courts have been relatively few, confusingly general, and often misleading. The relation between parent and subsidiary corporations, once described as enveloped in the mists of metaphor,<sup>3</sup> has not been clarified. The factual patterns which lead to shareholder or affiliate liability have not been clearly stated, and the reasons given by courts for imposing liability or withholding the remedy are frequently no more than an election of epithet.<sup>4</sup> In addition, some courts have failed to recognize that the reasons for disregarding the corporate entity in

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<sup>1</sup> *Fairfield County Turnpike Co. v. Thorpe*, 13 Conn. 173, 179 (1839) (Williams, C. J.) (dictum).

<sup>2</sup> See, e.g., *Bigelow v. RKO Radio Pictures, Inc.*, 170 F.2d 783 (7th Cir.) (injunction), *aff'd* 78 F. Supp. 250 (N.D. Ill. 1948); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945) (taxation); *Portsmouth Cotton Oil Refining Corp. v. Fourth Nat'l Bank*, 280 F. 879 (M.D. Ala.) (breach of warranty), *aff'd*, 284 F. 718 (5th Cir. 1922); *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247 (E.D. Wis. 1905) (illegal rebates); *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962) (personal injury claim); *Industrial Research Corp. v. General Motors Corp.*, 29 F.2d 623 (N.D. Ohio 1928) (service of process); *Telis v. Telis*, 132 N.J. Eq. 25, 26 A.2d 249 (1942) (dower in corporate realty).

<sup>3</sup> *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 155 N.E. 58 (1926) (Cardozo, J.).

<sup>4</sup> Compare *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955), *with* *Automotriz del Golfo de California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957). Compare *Wagner v. Manufacturers Trust Co.*, 237 App. Div. 175, 261 N.Y.S. 136 (1932), *aff'd*, 261 N.Y. 699, 185 N.E. 799, *with* *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942).

contract cases rest on entirely different policies than those obtaining in cases involving torts, taxation, or fiduciary or domestic relations. Analysis of the cases reveals, however, that the doctrine of disregarding the corporate entity embraces a number of separate policies which under particular circumstances outweigh the policy behind limited liability.

The conflict between limited liability and competing policies is sharpest in the contract cases because they involve consensual transactions. Before making a contract, a creditor is normally expected to ascertain that he is doing business with a corporation and that it will be able to satisfy his claim. This burden is imposed on the creditor because limited liability is a permissible object of incorporation,<sup>5</sup> and is regarded as a desirable and indeed necessary form of business organization in a private economy where risk capital is to be encouraged.<sup>6</sup> But the principle of limited liability does not protect the shareholder or affiliate whose conduct is calculated to defeat the reasonable expectations of the creditor.

Disregarding the corporate entity is an equitable doctrine which permits courts to penetrate form to find the substance of a transaction in order to prevent actual or constructive fraud or injustice.<sup>7</sup> While equitable in nature, it is not limited to equity jurisdiction,<sup>8</sup> nor does it appear that the existence of an alternative legal remedy bars its application at law or in equity. The kinds of fraud or wrong that appear to support relief under the doctrine appear to be independently actionable under other theories of liability, but the existence of alternative remedies against the defendant is rarely discussed.

An action in deceit would seem to be an alternative basis for recovery from a shareholder or affiliate in those cases where it is granted by the disregard device, but the deceit remedy might be barred in most cases by a short statute of limitations and by difficulties of proving a material misrepresentation, detrimental reliance, and intent. Another alternative remedy might be an action in the nature of breach of contract or warranty obligations expressed or implied in the circumstances of the credit transaction, but the statute of frauds would usually obstruct the creditor's proof of the promise by the defendant when the contract was with the corporation. Whatever the reasons, the theoretical availability of a deceit, contract, or warranty remedy does not seem to

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<sup>5</sup> See *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

<sup>6</sup> See *Gledhill v. Fisher & Co.*, 272 Mich. 353, 262 N.W. 371 (1935).

<sup>7</sup> *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951); *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

<sup>8</sup> *Home Fire Ins. Co. v. Barber*, 67 Neb. 644, 93 N.W. 1024 (1903). See generally F. J. Powell, *Parent and Subsidiary Corporation* ch. IX (1931) [hereinafter cited as Powell].

affect a consensual creditor's claim against a shareholder or affiliate when his apparent, corporate obligor is financially unable to respond.

The claims to be discussed arise in the context of the creditor plaintiff's contractual relationship with a corporation unable to meet its obligations, and his attempt to go behind his apparent obligor's separate legal personality to hold a shareholder or affiliate on one of several theories of action. Of the theories asserted in the contract cases, only that proceeding from defendant's legal fraud or wrong requires the court to disregard the corporate entity and impose liability on a defendant in its capacity as a shareholder or affiliate. While theories of agency, identity, and enterprise entity are often interjected in suits against shareholders or affiliates, these do not impose liability by ignoring the normal corporate barrier, but rather require the defendant to respond to legal obligations as a principal. The failure of the courts to distinguish between defendant's capacity as a principal and its capacity as a shareholder or affiliate is one source of the confusion that surrounds the device of disregarding the corporate entity. Since the characteristic of limited liability is the only essential difference between a shareholder or affiliate in a control relation to a corporation and a principal whose business is conducted by the corporate enterprise, it is necessary to consider the principle of limited liability whenever liability for a corporate obligation is imposed on a shareholder or affiliate. When there is sufficient reason for refusal to apply the principle of limited liability, it might be said that a shareholder is thereby indistinguishable from a principal and is responsible for the corporate obligation on ordinary agency grounds. In the contract cases, however, such reasoning is a perversion of doctrines used to impose liability on principals. Principals are legally responsible irrespective of fraud or wrong, but the cases establish that the courts require a showing of defendant's fraudulent or wrongful conduct before liability is imposed on a shareholder or affiliate which is not a principal.

The reasons for disregarding the corporate entity in cases not involving consensual transactions, principally tort cases, are different than in contract cases because the non-consensual creditor plaintiff has no real opportunity to choose not to do business with a corporation. While the policy behind limited liability might be as strong in tort cases as in contract cases,<sup>9</sup> the allocation of risks in non-consensual transactions rests on a different footing. There is very clearly a public policy limitation on the amount of risk that a shareholder or affiliate in a control relation with a corporation may effectively transfer to the

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<sup>9</sup> *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 155 N.E. 58 (1926); *Elenkrieg v. Siebrecht*, 238 N.Y. 254, 144 N.E. 519 (1924).

public by the maintenance and operation of a judgment-proof corporation, the business of which creates any substantial risk of harm to members of the public.<sup>10</sup> Since there is rarely any antecedent transaction by which the tort claimant's reasonable expectation may be measured, a remedy in disregard of a corporate entity barrier may be given only when the attempted transfer of economic risk is treated as a legal wrong in itself, and since there are few standards by which the propriety of the attempted transfer of risk may be measured, such a remedy is perhaps more frequently granted by treating the conduct creating the claim as that of the shareholder or affiliate.<sup>11</sup>

In still other kinds of cases, where the corporate entity barrier is not challenged by a contract or tort creditor, the reasons for ignoring apparent corporate limitations are different from those where a consensual or non-consensual credit transaction is involved. The policy behind limited liability may have no application. For example, in taxation cases, the issue is the impact of federal or state taxation policy on given business activity and the question is ultimately how much tax is due rather than the limitation of liability for its payment.<sup>12</sup> In a case where the question is the application to a corporation of an injunction previously issued against an affiliate, the issue is the extent of activity covered and financial liability is not involved.<sup>13</sup> Similarly, when the questions are whether trustees controlling a corporation with stock belonging to the trust must account for the affairs of the corporation or only for the shares of stock<sup>14</sup> and whether service of process on a subsidiary is effective to join a parent corporation in a lawsuit,<sup>15</sup> the respective policies involved are those of fiduciary standards and due process, and the principle of limited liability is not challenged. The question of dower

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<sup>10</sup> *Garden City Co. v. Burden*, 186 F.2d 651 (10th Cir. 1951); *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962); *Ross v. Pennsylvania R.R.*, 106 N.J.L. 536, 148 A. 741 (1930).

<sup>11</sup> The latter approach is the more realistic. To say that the corporate entity is ever disregarded is misleading because it is never disregarded for all purposes. What is perhaps better to say is that limited liability is inapplicable for a particular purpose and may not be successfully asserted by a particular party defendant. *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937). *Accord*, *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 222 N.Y.S. 883 (Sup. Ct. 1927). *See* *Powell* §§ 13 (f), 20.

<sup>12</sup> *E.g.*, *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945).

<sup>13</sup> *E.g.*, *Bigelow v. RKO Radio Pictures, Inc.*, 170 F.2d 783 (7th Cir.), *aff'd* 78 F. Supp. 250 (N.D. Ill. 1948).

<sup>14</sup> *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 222 N.Y.S. 883 (Sup. Ct. 1927).

<sup>15</sup> *Industrial Research Corp. v. General Motors Corp.*, 29 F.2d 623 (N.D. Ohio 1928).

rights in realty owned by a one-man corporation does not involve limited liability since the usual course of the corporate entity cases is reversed and it is sought to hold the corporation by way of an equitable attachment for the share holder's legal obligations. Only a question of statutory interpretation of the dower right is presented.<sup>16</sup>

Bankruptcy cases present two distinct problems. When a creditor seeks to hold a shareholder or affiliate for the whole of, or any deficiency in satisfying the corporate obligation, a question of the effect of limited liability is directly presented. In fact, most of the contract claims against a shareholder or affiliate arise only after discovery that the obligor corporation is insolvent and are frequently asserted during bankruptcy proceedings. Indeed, the solvency of the obligor corporation may be a ground for denying relief against a shareholder or affiliate.<sup>17</sup> A different question is presented, however, in bankruptcy cases when the creditor seeks not to hold the shareholder or affiliate on the corporate obligation, but to preclude its participation in the bankrupt's estate in the same or a prior class as a creditor competing with the complainant. The issue in this latter kind of case is not one of liability, but concerns the classification and validity of interests protected by a statutory scheme for corporate reorganization and bankruptcy administration,<sup>18</sup> and will not be discussed in this comment. While the conduct that might bar a shareholder or affiliate from asserting a competing claim against a bankrupt appears to be of the same kind that might warrant imposition of liability on it in disregard of the corporate entity, the equitable bar of a shareholder or affiliate claim in its capacity as a creditor is but one remedy on the path of creditor's remedies and does not require a fresh contribution to satisfy the creditor in full. It is therefore essential to analyse separately the two kinds of bankruptcy cases according to the relief sought and granted since the principle of limited liability is involved only when an affirmative contribution is sought from the shareholder or affiliate.

The propensity of courts to treat all of these cases as involving an issue of disregarding the corporate entity, and their failure to distinguish the capacity in which liability is imposed on the defendant is perhaps due to the conceptualization of the corporation as a legal person; the inference therefrom is that whenever someone else is to be responsible for the activity of the corporate person the entity of the corporate person must be disregarded. While this literal mindedness should long ago

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<sup>16</sup> *E.g.*, *Telis v. Telis*, 132 N.J. Eq. 25, 26 A.2d 249 (1942). *But see* *Frank v. Frank's, Inc.*, 9 N.J. 218, 87 A.2d 724 (1952).

<sup>17</sup> *See* *Powell* § 17.

<sup>18</sup> *See* *Pepper v. Litton*, 308 U.S. 295 (1939). *Accord*, *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939).

have subsided, there are relatively few cases with precisely similar issues reflecting the same conflict of policies, and many precedents are old. It should now be clear that the corporation is no more than a form of business organization. The occasional analogy to persons is deceptive, and it might be more accurate to perceive incorporation as a contractual term limiting liability, imputed by law to the agreements of all who would deal with the incorporated enterprise and subject to application, construction, waiver, and estoppel on ordinary contract principles. This notion has some utility in explaining the results in contract cases, but its application in cases where the plaintiff and the corporation were not in a consensual relationship, from which acceptance might be inferred, is open to doubt. There is little reason, however, for discarding the doctrine of defendant's fraud or wrong in disregarding the corporate entity, which when properly applied can adequately explain the imposition of liability on a shareholder or affiliate which is not a principal. It is noteworthy that while the opinions in cases purportedly involving an issue of disregarding the corporate entity usually do not state the grounds on which liability is imposed sufficiently to enable prediction, the decisions nevertheless adequately protect the principle of limited liability by not imposing liability in the absence of a legal fraud or wrong.

The contract cases are a source of confusion in the law of disregarding the corporate entity because they present the sharpest conflict between the policy behind limited liability and those policies affording relief against a shareholder or affiliate, and because the courts fail to make statements of the real grounds for liability. For this reason, the following discussion deals primarily with consensual creditor's claims against a shareholder, either individual or corporate as in the parent and subsidiary corporation situation, or affiliate, where the obligor corporation and the defendant are controlled by a common shareholder. While the particular conduct of the defendant that supports liability may be peculiar to one of these kinds of defendants, the principles on which liability is imposed are the same. For example, it is unlikely that an affiliate could lead a creditor to believe that he was not dealing with a corporation, but the same principle would suggest liability when it concealed the affiliated nature of the obligor in order to create the expectation that it would be responsible for the debt. It is therefore unnecessary for the purposes of discussion to distinguish between the kinds of defendants.

## II. THE ELEMENTS OF SHAREHOLDER OR AFFILIATE LIABILITY

Contract creditors have attempted to hold shareholders and affiliates on four distinct theories: disregarding the corporate entity, agency,

identity, and enterprise entity. While one or more of these theories are often advocated in the alternative, it is only the theory of disregarding the corporate entity that requires imposition of liability on a defendant in its capacity as a shareholder or affiliate because the other three theories impose liability on principals who are not protected by the principle of limited liability. According to courts and scholars the liability of a defendant in its capacity as a shareholder or affiliate is governed by three elements: the instrumentality rule, defendant's fraud or wrong, and plaintiff's injury. The second element is often defined to include the third. While the latter two elements are clearly related to defendant's liability as a shareholder or affiliate, the so-called instrumentality rule is open to criticism because it does not help to explain the cases but rather tends to interject false issues which becloud understanding of the process of disregarding the corporate entity and hamper prediction of liability of shareholders or affiliates which are not principals.

### A. *The Instrumentality Rule*

The so-called instrumentality rule is cited as the first condition to relief against a shareholder or affiliate. Professor Powell formulated the rule from statements in cases where the separate corporate entity was held to be no barrier to the relief sought.<sup>19</sup> In his influential work on parent and subsidiary corporations, he consisely stated the rule as follows: "So far as the question of control alone is concerned, the parent corporation will be responsible for the obligations of its subsidiary when its control has been exercised to such a degree that the subsidiary has become its mere instrumentality."<sup>20</sup> This formulation or indistinguishable variations on it have been widely repeated by American courts.<sup>21</sup> The difficulty with the instrumentality rule is that it does not provide meaningful criteria for deciding when to disregard the corporate entity. It is used as a substitute for reasoned analysis of the

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<sup>19</sup> In a leading case, the United States Supreme Court said: "where such ownership of stock is resorted to, not for the purpose of participating in the affairs of the corporation in which it is held *in a manner that is normal and usual to stockholders*, but for the purpose of making it *a mere agent, or instrumentality or department of another company*, the courts will look through the forms to the realities of the relation between the companies as if the corporate agency did not exist and will deal with them as the justice of the case may require." *United States v. Reading Co.*, 253 U.S. 26, 62 (1920) (emphasis added). *Accord*, *United States v. Lehigh Valley R.R.*, 220 U.S. 257 (1911). It should be noted that neither of these cases involves the principle of limited liability, but statutory prohibitions sought to be avoided by the subsidiary device.

<sup>20</sup> Powell § 5.

<sup>21</sup> *Id.* See W. M. Fletcher, *Cyclopedia of Corporations* §§ 41, 42 (perm. ed. rev. 1963) [hereinafter cited as Fletcher]; R. S. Stevens, *Private Corporations* § 18 (2d ed. 1949).

real factors behind decisions.<sup>22</sup> In one sense, all corporations are the instrumentalities of their shareholders since there would be little reason to incorporate were it not to advance the interests of the shareholders.<sup>23</sup> Indeed, corporate instrumentalities are recognized to be permissible shields against liability in the many situations where the principle of limited liability prevails.<sup>24</sup>

What facts constitute a corporation an instrumentality for purposes of the rule is an unanswerable question. A catalogue of the most common situations includes those recited in cases where relief is granted. But these same facts are largely mirrored in those cases where relief is denied. No combination or permutation of the commonly reported facts upon which conclusions that certain corporations were or were not instrumentalities has ever been established as controlling.<sup>25</sup> Powell has catalogued the following factors: ownership of all or most of the corporation stock; common directors or officers; the parent finances the subsidiary; the corporation is inadequately capitalized; the defendant pays corporation expenses; the corporation has no assets or business other than that acquired through the defendant; the defendant treats the corporation as a department; the defendant used corporation property as its own; the directors and officers take orders from the defendant; the corporate formalities, such as directors meetings and separate records, are not regularly observed.<sup>26</sup> The presence of all or a number of these factors clearly shows a degree of dominance by the shareholder or affiliate, but the question remains whether such dominance is a legitimate basis for disregarding the corporate entity.

An analysis of the cases reveals that some degree of dominance is found in all the cases where plaintiffs seek successfully<sup>27</sup> or unsuccessfully<sup>28</sup> to hold liable a shareholder or affiliate. While it is impossible to make a comparison of defendants' dominance in the cases, it may be noted that a control relationship through stock ownership or a common shareholder, which is essential to proof of defendant's causation of plaintiff's loss, exists in virtually all of the cases discussing the issue.<sup>29</sup>

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<sup>22</sup> See E. Latty, *Subsidiaries and Affiliated Corporations* 157-58 (1936) [hereinafter cited as Latty].

<sup>23</sup> *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937).

<sup>24</sup> *Accord*, *Carlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948); *Gledhill v. Fisher & Co.*, 272 Mich. 353, 262 N.W. 371 (1935); *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, *cert. denied*, 300 U.S. 655 (1936).

<sup>25</sup> See Powell § 6; Fletcher § 43.

<sup>26</sup> Powell § 6.

<sup>27</sup> See cases cited notes 2, 7 and 10 *supra*.

<sup>28</sup> See cases cited notes 9 and 24 *supra*.

<sup>29</sup> Powell § 6(a).



Some common directors and officers are found in the parent and subsidiary cases, but uniformity of leadership is rarely complete.<sup>30</sup> Financing by the defendant is often recited but rarely relied upon as a basis for liability.<sup>31</sup> Incorporation for the very purpose of avoiding liability is approved by some courts and declared to be against public policy by others.<sup>32</sup> Similarly, cries of inadequate capitalization have met with varied response in the courts.<sup>33</sup>

The remaining factors catalogued by Powell and often recited in opinions include defendant's use of corporation property, supervising officers and directors and responsibility for failure to have director's meetings or keep separate records. These are instances of intermeddling in the corporation's affairs. Without showing where these harm the plaintiff, it is difficult to understand why such intermeddling should result in liability. Responsibility should not be found because the application of the instrumentality rule requires, additionally, a legal fraud or wrong. It seems, however, that such intermeddling may have become confused with the requirement of a wrong and received treatment as the wrong itself in some cases.<sup>34</sup> One of these remaining factors, officers or directors taking orders from the defendant owner, is particularly open to question. When such orders are in a short circuit of the corporation's formal governmental structure, they are simply intermeddling, but when they are limited to communication of the owner's goals it is doubtful that such order giving constitutes intermeddling for purposes of the rule. If all orders of the shareholder to corporate officers or direc-

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<sup>30</sup> See, e.g., *May Dep't. Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937); *Ross v. Pennsylvania R.R.*, 106 N.J.L. 536, 148 A. 741 (1930). But see, e.g., *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942).

<sup>31</sup> See Powell § 6(c).

<sup>32</sup> Compare *Elenkrieg v. Siebrecht*, 238 N.Y. 254, 144 N.E. 519 (1924), with *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962). The issue of liability avoidance is highlighted in the so-called one-man corporation cases, and incorporation therein is generally upheld. *W. D. Miller Lumber Corp. v. Miller*, 225 Ore. 427, 357 P.2d 503 (1960). But cf. *Shamrock Oil and Gas Co. v. Ethridge*, 159 F. Supp. 693 (D. Colo. 1958).

<sup>33</sup> Compare *Carlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948), with *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958). At least one court has said that even if the defendant is liable for inadequate capitalization, it is only to the extent of the inadequacy, and not necessarily to the extent of the claim. *Arnold v. Phillips (In re Southern Brewing Co.)*, 117 F.2d 497 (5th Cir.), cert. denied, 313 U.S. 583 (1947). See also *Luckenback S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.) (semble), cert. denied, 254 U.S. 644 (1920).

<sup>34</sup> See *Garden City Co. v. Burden*, 186 F.2d 651 (10th Cir. 1951); *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942); *Stark Elec. R.R. v. McGinty Contracting Co.*, 238 F. 657 (6th Cir. 1917); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951); *Automotriz del Golfo de California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957); *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957); *Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 105 P.2d 649 (1940).

tors were treated as intermeddling, impliedly illegitimate, defendants might be penalized for exercising their legal rights to control the corporation.<sup>35</sup> The inescapable conclusion is that the factors of an instrumentality are more or less present in all cases where relief against a shareholder or affiliate is sought, but their degree is immeasurable and their effect on the outcome indeterminable.<sup>36</sup> Perhaps the only accurate observation that can be made of the factors catalogued by Powell and cited by courts is that the strength and number of these factors in a case may be symptomatic of a legal wrong. The courts may then grant relief for that wrong without clearly pointing it out.<sup>37</sup>

For the purposes of the instrumentality rule it is immaterial whether the party defendant sought to be charged with the corporate obligation is an individual or corporate shareholder, or an affiliated corporation whose control of the obligor is effected through a common controlling shareholder.<sup>38</sup> While courts have experienced no difficulty in penetrating the affiliated organization, some reservation is shown when the usual configuration of the suit is reversed and the plaintiff seeks to hold a subsidiary for the obligation of the parent corporation. This may illustrate that it is the power of control rather than a mere control relationship that warrants relief against a shareholder in a proper case.<sup>39</sup>

In addition to the term "instrumentality," many other "emotive epithets synonymous with and as empty"<sup>40</sup> are used. The obligor corporation is frequently described as an adjunct, agent,<sup>41</sup> alter ego, branch, department, form, puppet, sham, subterfuge, or tool, or found to be an identity of the shareholder or affiliate.<sup>42</sup> This plethora of terms makes discussion and analysis difficult because none of them provide meaningful criteria for decision. No logical distinction can be made between those fact situations supporting a conclusion that the obligor is an instrumentality and those supporting a different epithet. One

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<sup>35</sup> See generally A. Berle & G. Means, *The Modern Corporation and Private Property* bk. II (1933).

<sup>36</sup> Compare cases cited notes, 2, 7 and 10 *supra* with cases cited notes 9 and 24 *supra*.

<sup>37</sup> See cases cited note 34 *supra*.

<sup>38</sup> See *Luckenback S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.), *cert. denied*, 254 U.S. 644 (1920); *Powell* § 10. Cf. *Bigelow v. RKO Radio Pictures, Inc.*, 170 F.2d 783 (7th Cir. 1948); *Portsmouth Cotton Oil Refining Corp. v. Fourth Nat'l Bank*, 280 F. 879 (M.D. Ala.), *aff'd*, 284 F. 718 (5th Cir. 1922).

<sup>39</sup> See *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265 (2d Cir. 1929) (L. Hand, J.).

<sup>40</sup> Latty 157-58.

<sup>41</sup> Agency is usually used in a non-legal sense in this manner. See *New York Trust Co. v. Carpenter*, 250 F. 668 (6th Cir. 1918) (third Carpenter case).

<sup>42</sup> See generally Latty.

distinction, however, should be made. In two classes of what may be described as "identity" cases, liability is seemingly imposed independently of the instrumentality rule.

In the first class, the shareholder or affiliate is treated as the party primarily liable because there is at least some doubt whether the conduct or obligation is that of the corporation or that of the shareholder or affiliate.<sup>43</sup> In a second class of "identity" case, the formal structure of the corporate entity is found in such disrepair that it can legally exist only in the teeth of state corporation laws. Its existence is difficult to observe in fact or in law.<sup>44</sup> The question seemingly answered in these cases of extreme disregard of formality is whether a corporation exists rather than whether a remedy ignoring it should be given.<sup>45</sup>

With the exception of cases defining the instrumentality rule or one of its doctrinal synonyms very broadly, a finding that the apparent obligor corporation was in fact the instrumentality of the shareholder or affiliate will not alone result in disregarding the corporate obligor's separate entity.<sup>46</sup> An additional finding of a legal fraud or wrong on the part of the defendant is required.<sup>47</sup>

### B. *The Fraud or Wrong of the Defendant*

A showing that the defendant shareholder or affiliate is guilty of fraud or wrong is cited as the second condition to relief in disregard of a corporate entity barrier.<sup>48</sup> Such fraud or wrong is broadly defined, and while it is usually an independently actionable wrong,<sup>49</sup> or an independent ground for relief,<sup>50</sup> it occasionally appears to be something less than actionable conduct on the part of the shareholder or affiliate.

<sup>43</sup> See *Portsmouth Cotton Oil Refining Corp. v. Fourth Nat'l Bank*, 280 F.879 (M.D. Ala.), *aff'd*, 284 F. 718 (5th Cir. 1922); *Garden City Co. v. Burden*, 186 F.2d 651 (10th Cir. 1951); *Stark Elec. R.R. v. McGinty Contracting Co.*, 238 F. 657 (6th Cir. 1917). *Cf. Luckenbach S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.) (*semble*), *cert denied*, 254 U.S. 644 (1920); *Industrial Research Corp. v. General Motors Corp.*, 29 F.2d 623 (N.D. Ohio 1928). See Powell §24.

<sup>44</sup> *E.g.*, *Automotriz del Golfo de California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957). *Cf. Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

<sup>45</sup> *E.g.*, cases cited note 44 *supra*.

<sup>46</sup> Cases cited notes 9 and 24 *supra*; *Frank v. Frank's, Inc.*, 9 N.J. 218, 87 A.2d 724 (1952). See generally Fletcher §§ 41-48; Powell § 12.

<sup>47</sup> Powell § 12. Query whether the two requirements are not often confused and the operation of an instrumentality becomes itself a wrong. See cases cited note 24 *supra*.

<sup>48</sup> Powell ch. III.

<sup>49</sup> *Codomo v. Emmanuel*, 91 So. 2d 653 (Fla. 1956); *Quaid v. Ratkowsky*, 183 App. Div. 428, 170 N.Y.S. 812, *aff'd*, 224 N.Y. 624, 121 N.E. 887 (1918).

<sup>50</sup> *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951); *Larson v. Western Underwriters, Inc.*, 77 S.D. 157, 87 N.W.2d 883 (1958).

The oft-quoted statement of policy is that, "when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."<sup>51</sup>

While perhaps an overstatement,<sup>52</sup> the declaration has been frequently repeated and shareholders or affiliates have regularly been held responsible for corporate obligations when a proper showing of fraud, wrong, or illegality in the use of the corporate device has been made.<sup>53</sup> The contract cases, involving private, consensual relationships, rarely involve illegality,<sup>54</sup> and the battle lines are usually drawn on issues of fraud or wrong.

On occasion, this second element of liability is defined to include the third: injury, injustice, or inequity to the plaintiff if a remedy is denied. In these cases the shareholder or affiliate is said not to have wronged or defrauded the plaintiff unless there would be extraordinary injury in the absence of relief.<sup>55</sup> Restating the elements of liability in this manner has no apparent effect on the substance of the remedy.<sup>56</sup>

The fraud or wrong of the defendant shareholder or affiliate is invariably alluded to but rarely specified in opinions in cases granting relief. In many cases it seems to be stated as a conclusion and the facts which would support such a conclusion are not clearly pointed out by the courts. Taking at full value the many statements to the effect that operation of a corporation as an instrumentality, without more, will not support relief,<sup>57</sup> an inventory of the kinds of fraud or wrong supporting relief against a shareholder or affiliate can be made.

In one class of cases, relief is based on conduct of the defendant which takes place *before* the plaintiff contracted with or extended credit

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<sup>51</sup> *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247 (E.D. Wis. 1905) (Sanborn, J.) (dictum in part).

<sup>52</sup> No case has been found holding a shareholder not in a control relation nor privy to a control group liable on a corporate obligation. *But cf.* *Codomo v. Emmanuel*, 91 So.2d 653 (Fla. 1956) (wife liable as silent partner in corporate fraud of husband).

<sup>53</sup> See cases cited notes 7, 10, 49 and 50 *supra*; Powell § 12. See generally M. Wormser, *Disregard of the Corporate Fiction and Allied Corporate Problems* 1-85 (1927).

<sup>54</sup> The notable exception is *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937) (illegal contract utility rate), one of the better reasoned cases.

<sup>55</sup> Powell § 14.

<sup>56</sup> Powell favored three elements to facilitate understanding of factors which might bar relief. Powell § 14. But California has adopted a two element rule with no apparent difference in result. See *Automotriz del California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957); *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957); *Carlesmo v. Schweble*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948); *Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 105 P.2d 649 (1940).

<sup>57</sup> See cases cited notes 9 and 24 *supra*; Fletcher §§ 41-48; Powell § 12.

to the corporation. The conduct is usually in the form of a misrepresentation of one of three types. First, the defendant may have concealed the fact of incorporation. For example, in *Shafford v. Otto Sales Company*<sup>58</sup> plaintiff was a salesman who sued to recover commissions on the sale of cocoanut made in behalf of defendant Otto who was doing business as Otto Sales Company during the period of plaintiff's negotiations with Otto. Subsequently, Otto almost secretly incorporated his business with nominal capital and plaintiff discovered that his contract had been concluded during the life of and assertedly with Otto Sales Company, Inc. Furthermore, Otto having delayed plaintiff's knowledge that the sales had been concluded, the corporation had run through Otto's relatively large capital contribution and was quite unable to pay the commissions. While the court discusses at length the inadequacy of the corporation's capital, it notes that "plaintiff did not know that Otto Sales Company was a corporation, nor did he understand that he was dealing with a corporation."<sup>59</sup> Plaintiff had previously been denied relief against Otto for failure to show that he believed he was dealing with Otto personally and that the corporation was undercapitalized.<sup>60</sup> If inadequate capitalization was a ground for relief, it was clearly not independent but conjunctive with Otto's suppression of the fact of incorporation.<sup>61</sup>

Second, there may have been a representation that the defendant stood behind the corporation, a sort of equitable contract of guarantee. In *Weisser v. Mursam Shoe Corporation*<sup>62</sup> plaintiffs agreed to lease a building to Murray and Samuel Rosenberg who told them the tenant was to be Mursam Shoe Corporation and explained: "the name Mursam was an abbreviation for Murray and Samuel, and that he and his brother were the corporation and 'stood behind' the lease."<sup>63</sup> The corporation was in fact a so-called "leasehold" corporation, without assets or business except through defendants, maintained solely for the purpose of insulating defendants and their occupying corporations under subleases from liability on the lease. After performing for fourteen years of the fifteen year lease, Mursam defaulted and plaintiffs sued the Rosenberg brothers individually. Their allegations and affidavit were held to create triable issues.<sup>64</sup> Since respectable authority has upheld the use of lease-

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<sup>58</sup> 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

<sup>59</sup> *Id.* at 431, 308 P.2d at 430.

<sup>60</sup> *Shafford v. Otto Sales Co.*, 119 Cal. App. 2d 849, 260 P.2d 269 (1953).

<sup>61</sup> *Id.* Cf. *Richmond & I. Const. Co. v. Richmond, N., I. & B. R.R.*, 68 F. 105 (6th Cir. 1895).

<sup>62</sup> 127 F.2d 344 (2d Cir. 1942).

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 345.

hold corporations when dealing openly,<sup>65</sup> the real ground for the decision was apparently the representation guaranteeing the obligation or the operating nature of the corporation.<sup>66</sup>

Third, there may have been a misrepresentation of the corporation's financial condition or the adequacy of its capital. This reason for imposing liability is perhaps the least visible of all, possibly because it rarely exists alone, and probably because it would be difficult to show in cases where creditors have a right to rely on an appearance of wealth. This may be the case with small creditors where business usage and the size of the account would not warrant investigation of the corporate debtor's credit. Furthermore, shareholders able to respond in damages are not likely to consciously attempt this sort of deception with creditors whose claims would be sizable and who could be expected to investigate the obligor corporation's worth. Thus in most circumstances where this sort of misrepresentation might occur, the claim could be expected to be too small to litigate or the shareholder's worth would not warrant litigation. There are cases, however, where the only reason that can logically be advanced for the imposition of liability is a misrepresentation of worth. In *Portsmouth Cotton Oil Refining Corporation v. Fourth National Bank*,<sup>67</sup> for example, the defendant bank acquired the assets of the corporation on foreclosure, incorporated it through dummies, and financed it through loans, seeking to recoup losses on old loans on the security of the assets. The bank was held liable for breach of warranty on cotton oil sold by the corporation. While the case is beclouded by the bank's defense of ultra vires, the only sound reason that the bank could have been held liable was that, in resurrecting a diseased business and giving it life through loans, it had sent it into the marketplace with an appearance of financial soundness to sell faulty goods, an implied misrepresentation of wealth.<sup>68</sup>

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<sup>65</sup> *Wagner v. Manufacturers Trust Co.*, 237 App. Div. 175, 261 N.Y.S. 136, *aff'd*, 261 N.Y. 699, 185 N.E. 799 (1932); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, *cert. denied*, 300 U.S. 655 (1936). In the principal case Judge Frank chafes at the *Wagner* decision, avoiding it under conflict of laws rules since the real estate was not located in New York, while yearning for "the old untrammelled days before *Erie R.R. v. Tompkins* . . ." when liability could have been imposed on the authority of one of the more liberal federal cases. 127 F.2d 347-48 & nn.7-10.

<sup>66</sup> *Accord*, *Quaid v. Ratkowsky*, 183 App. Div. 428, 170 N.Y.S. 812, *aff'd*, 224 N.Y. 624, 121 N.E. 887 (1918).

<sup>67</sup> 280 F. 879 (M.D. Ala.), *aff'd*, 284 F. 718 (5th Cir. 1922).

<sup>68</sup> Breach of warranty cases are arguably more like tort cases than other contract cases, but the impermissible allocation of tort risk reason for disregarding the corporate entity is not clearly applicable when, as in the principal case, the plaintiff is a buyer who knew he was dealing with a corporation. *Cf. Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 105 P.2d 649 (1940).

Not to be confused with representations of adequacy of capitalization or worth is inadequate capitalization per se. The context in which claims against a shareholder or affiliate arise is usually the insolvency of the obligor corporation. Such insolvency is not infrequently caused as a matter of economics solely or in part by inadequate original capitalization. Whatever its effect, inadequate original capitalization may exist without a representation of adequacy or worth, and does not appear to be a satisfactory ground for relief.<sup>69</sup>

The foregoing examples illustrate the kinds of wrongs occurring before the contract is made or credit extended for which relief is granted against a shareholder or affiliate. In a second class of cases, the wrongful conduct is subsequent to the formation of the contract. In *Larson v. Western Underwriters, Incorporated*,<sup>70</sup> plaintiffs entered into a land contract for the purchase of a home from the defendant corporation which had total assets consisting of three houses encumbered by mortgages. The corporation, used to conduct the business of Jacobson who was principal shareholder, a director, and an officer, misapplied plaintiffs' contract payments, which exceeded the mortgage payments, and was in imminent danger of insolvency. To protect the plaintiffs' equity in the home, the court held Jacobson accountable. There was no showing of fraud or wrong prior to the purchase, but the court held the shareholder liable because he failed to apply plaintiffs' payments to the preservation of the property, which plaintiffs could reasonably have expected from their knowledge of the corporation's business.<sup>71</sup>

In *Henderson v. Rounds & Porter Lumber Company*,<sup>72</sup> the parent corporation operated a subsidiary as a source of wood flooring at prices substantially below an inflated market. The subsidiary was maintained bankrupt but solvent in the equity sense by capital contributions of the parent. Upon acquiring control stock independent of a former control group, and while liquidation could have satisfied creditors, the parent increased its discount and ceased contributions which resulted in almost immediate insolvency, leaving the parent the only secured creditor. Going farther than would be required by the so-called "deep rock" doctrine,<sup>73</sup> the parent corporation was held fully accountable to creditors.<sup>74</sup>

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<sup>69</sup> *Carlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948). *Accord*, *Hanson v. Bradley*, 298 Mass. 371, 10 N.E.2d 259 (1937).

<sup>70</sup> 77 S.D. 157, 87 N.W.2d 833 (1958).

<sup>71</sup> The opinion in this case cannot be described as clear.

<sup>72</sup> 99 F. Supp. 376 (W.D. Ark. 1951).

<sup>73</sup> *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939) (creditor loses priority against debtor in reorganization for manipulation).

<sup>74</sup> 99 F. Supp. at 384.

The *Larson* and *Henderson* cases show that a shareholder or affiliate may be liable for certain conduct in managing the corporate obligor subsequent to contracting or the extension of credit by the plaintiff.<sup>75</sup> The limitation on this liability can be gathered in part from *Bartle v. Home Owners Co-operative, Incorporated*.<sup>76</sup> There defendant was a co-operative corporation organized for the purpose of providing low cost housing for veterans. Its wholly owned subsidiary, Westerlea, was organized to undertake construction and operated so that it would make no profit to insure a savings to the veterans. Westerlea failed, and by extension agreement, the creditors continued operation until it became bankrupt several years later. The trustee in bankruptcy was denied recovery to the extent of the creditors' claims from the parent corporation because all of the creditors knew of the real purpose of the corporation. As the dissenting judge points out, the parent's shareholders became the beneficiaries of the subsidiary's insolvency, but the majority held that such a purpose was within the limits of public policy. What is to be noted is that there was a *subsisting* practice reasonably known to all creditors of the subsidiary of removing all gain and obviously some assets.

Subsisting management or mismanagement practices are probably a limitation on relief for the subsequent conduct of a shareholder or affiliate because they give plaintiffs reasonable notice of the risks they incur when extending credit to a particular corporation. The "leasehold" cases, where deliberate default would appear to be condoned by the courts, illustrate that a shareholder or affiliate will not incur liability when the plaintiff knew that the corporation was utilized solely as a shield against liability.<sup>77</sup> The pattern of conduct supporting liability where there is no antecedent misrepresentation thus seems to be defendant's stripping the corporation of assets or otherwise impairing the plaintiff's security when such conduct by the defendant is not a subsisting practice, or when the circumstances surrounding the making of the contract do not give the plaintiff notice of the likelihood of such conduct. In neither class of cases are the reasonable expectations of the shareholder or affiliate defeated.

It is difficult to describe the nature of the legal wrong that supports relief against a shareholder or affiliate when the wrong occurs subsequent to the credit transaction. Antecedent wrongs are analogous to the

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<sup>75</sup> *Accord*, *Pepper v. Litton*, 308 U.S. 295 (1939).

<sup>76</sup> 309 N.Y. 103, 127 N.E.2d 832 (1955).

<sup>77</sup> *Wagner v. Manufacturers Trust Co.*, 237 App. Div. 175, 261 N.Y.S. 136, *aff'd*, 261 N.Y. 699, 185 N.E. 799 (1932); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, *cert. denied*, 300 U.S. 655 (1936). *Accord*, *Gledhill v. Fisher & Co.*, 272 Mich. 353, 262 N.W. 371 (1935). *Cf.* *Majestic Co. v. Orpheum Circuit*, 21 F.2d 720 (8th Cir. 1927).



tort of deceit, but this analogy does not fit conduct which involves no misrepresentation of present fact and which occurs after credit is extended. The wrong is more like a breach of warranty that the corporation will be managed in a manner conducive to the preservation of adequate capital security for the obligation. Nevertheless, the relatively few cases concerning this kind of wrong appear to shift all or none of the loss to the defendant without differentiating between the loss that may be due to the breach of such a warranty and the loss that would be due to business risks assumed by the plaintiff. This remedial inconsistency might be explained by arguing that the defendant should have the burden of proving the business loss in mitigation, but would usually be unable to sustain the burden. The warranty analogy is further beset, however, with a statute of frauds problem since it was the corporation which made the agreement with the plaintiff. A third analogy is also possible. Creditors' remedies are generally directed against officers and directors who control the activity of the corporation. Perhaps the best explanation of creditor recovery in these occasional cases is a special creditors' remedy arising when the shareholder or affiliate, by causing the corporation to deal with the plaintiff, has established a duty to conduct itself in a manner consistent with the preservation of such capital as would reasonably be expected under the circumstances of the credit relationship. It is liable to the plaintiff for the breach of this duty because of its effective control and lack of notice that its control would be used to impair the corporate wealth relied upon as security for the debt. Whatever the nature of the wrong in these cases, a creditor's recovery may be predicted when defendant's conduct is inconsistent with plaintiff's reasonable understanding and expectation of the defendant's control and effective management of the corporation at the initiation of the consensual credit relationship.

In a third class of cases the reason for shareholder or affiliate liability cannot be described as a fraud or wrong in the common law sense, but is better described as a supervening illegality which taints a prior, lawful contractual relationship and makes the continuation of the terms of the prior relationship wrongful as to the plaintiff. In *May Department Stores Company v. Union Electric Light & Power Company*,<sup>78</sup> defendant power company acquired control of a subsidiary power company which supplied electric power to plaintiff under contract. Utility rate legislation limited the rates that defendant could lawfully charge, but did not disturb the lawfulness of the subsidiary's prior contract. Under defendant's control, the subsidiary was relieved of all of its former customers except plaintiff, and its power distribution system

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<sup>78</sup> 341 Mo. 288, 107 S.W.2d 41 (1937).

integrated with defendant's. On plaintiff's suit to recover the difference between the contract rates paid and the lower, permissible tariff rates, defendant was held liable on the ground that the statutory scheme made the rates charged unlawful. The court was satisfied that defendant had used its control to wrongfully achieve by the subsidiary device what it could not do directly.

It is doubtful whether cases like *May* involve disregarding the corporate entity. The subsidiary in *May* was not in default nor affected by the statute, thus was not obligated to the plaintiff. An acceptable analysis might be that the defendant was liable for violating the statute protecting electric power consumers independent of its relation to the subsidiary, just as it might be subject to injunction for statutory violations.<sup>79</sup> Thus in the consensual relationship situation, subsequent illegality may warrant a remedy against a shareholder or affiliate, even in the absence of an obligation on the part of the corporate contractor.<sup>80</sup>

In the absence of a fraud or wrong, or illegality in one of the foregoing classes, relief against a shareholder or affiliate has been uniformly denied in the contract cases.<sup>81</sup>

Inadequate capitalization is frequently discussed and often treated as supporting shareholder or affiliate liability.<sup>82</sup> There is sound authority that, absent a legal fraud or wrong, inadequate capitalization is not itself a basis for relief in the contract cases.<sup>83</sup> Unless there is a misrepresentation, the consensual creditor with notice that he is dealing with a corporation should be taken to have assumed the risk of the

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<sup>79</sup> Cf. *United States v. Milwaukee Refrigerator Transit Corp.*, 127 F. 247 (E.D. Wis. 1905); cases cited note 19 *supra*.

<sup>80</sup> Cf. *Industrial Research Corp. v. General Motors Corp.*, 29 F.2d 623 (N.D. Ohio 1928).

<sup>81</sup> *New York Trust Co. v. Carpenter*, 250 F. 668 (6th Cir. 1918); *Richmond & I. Const. Co. v. Richmond, N. I. & B.R.R.*, 68 F. 105 (6th Cir. 1895); *Carlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948); *Hanson v. Bradley*, 298 Mass. 371, 10 N.E.2d 259 (1937); *Finley v. Union Joint Stock Land Bank*, 281 Mich. 214, 274 N.W. 768 (1937); *Gledhill v. Fisher & Co.*, 272 Mich. 353, 262 N.W. 371 (1935); *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955); *Lowendahl v. Baltimore & O.R.R.*, 247 App. Div. 144, 287 N.Y.S. 62, *aff'd*, 272 N.Y. 360, 6 N.E.2d 56 (1936); *Wagner v. Manufacturers Trust Co.*, 237 App. Div. 175, 261 N.Y.S. 136, *aff'd*, 261 N.Y. 699, 185 N.E. 799 (1932); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, *cert. denied*, 300 U.S. 655 (1936); *Ohio Edison Co. v. Warner Coal Co.*, 79 Ohio App. 437, 72 N.E.2d 207 (1946). See *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265 (2d Cir. 1929).

<sup>82</sup> See, e.g., *Automotriz del Golfe de California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957).

<sup>83</sup> *Carlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948); *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955). See cases cited note 81 *supra*.

insolvency of his debtor. It is difficult to perceive a reason why he should not be permitted to do so, and when he has had an opportunity to investigate the financial reputation of his debtor, it is difficult to maintain that he has not assumed the risk. Arguably the small creditor trusting the corporation's credit on an impression of wealth is in a different position since his account would not ordinarily warrant the expense of investigation. He would therefore act reasonably in reliance on an appearance of wealth, but authority is lacking and unlikely to develop on this point because such small claims do not produce litigation. When the shareholder or affiliate causes the corporation to deal with the small creditor, it should be guilty of an implied misrepresentation of worth according to business usage, and liable then on the model of a deceit action for the bad account.

Tort cases present an entirely different problem with respect to adequacy of capitalization since tort plaintiffs are rarely consensual creditors and cannot be taken to have assumed the risk of insolvency. Sound public policy might require a certain capitalization before recognition of limitations on liability when the public is exposed to the risks of harm by defendant shareholder's or affiliate's business.<sup>84</sup> Cases not involving consensual creditors are therefore frequently inapposite to contract claims problems.

Inadequate capitalization doctrines also present thorny problems of measurement. What is inadequate for the purpose of economic decisions like entry into business, the extension of credit, or for taxation<sup>85</sup> need not be and probably is not the same as that for the purpose of holding a shareholder or affiliate. There is a danger that hindsight might be used in the determination. Furthermore, such a doctrine of wrong nullifies the benefits of the corporate form of business organization which is designed to encourage risk capital. Should a creditor be willing to take the risk of insolvency of his debtor corporation, the law would not, in the absence of another legal wrong, imply any sort of equitable guarantee of objective adequacy of capital which would tend to discourage entrepreneurial capital.

Since the contract claims against shareholders and affiliates usually arise on the insolvency of the obligor corporation, and since inadequate capitalization in the economic sense is not infrequently a cause of corporate insolvency, it is not surprising that it is present in many of the contract cases. But like the other factors embraced by the instru-

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<sup>84</sup> See *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962); cf. *Ross v. Pennsylvania R.R.*, 106 N.J.L. 536, 148 A. 741, *aff'd* 7 N.J. Misc. 469, 146 A. 37 (1930).

<sup>85</sup> See *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir.) *cert denied*, 352 U.S. 1031 (1956) (thin incorporation: debt treated as equity for income tax purposes).

mentality rule, it is more or less present in all cases against shareholders or affiliates, and its effect immeasurable.<sup>86</sup> Its logical difficulties and adverse policy implications should recommend its relegation to the role of supporting inferences of legal fraud or wrong which, like the instrumentality rule, may be its real utility.<sup>87</sup>

There remains a question whether the fraud or wrong of the defendant shareholder or affiliate is a sufficient basis for relief without showing that the defendant disregarded the corporate obligor's separate existence, principally by failure to observe corporate formalities. The only common element of denounced dominance that can be found in the cases granting relief is the control relationship.<sup>88</sup> Other factors recur but seem, as does inadequate capitalization, to be more symptomatic of wrong than wrong. It might be anticipated that a shareholder intending to defraud creditors or finding an opportunity to do so would tend to avoid the time and expense of formality, although a clever wrongdoer might appreciate the favorable evidentiary inferences of strict observation. Just such a question was presented to the United States Supreme Court, and the answer is perplexing.

In *United States v. Elgin, Joliet & Eastern Railway Company*,<sup>89</sup> the United States sued to enjoin violation of federal law prohibiting railroads from transporting articles of their own manufacture to discourage rate favors. Defendant railroad was in violation for transporting products of United States Steel, its parent corporation, if the parent-subsidiary relation did not preclude application. The court<sup>90</sup> held that the mere power of control did not warrant disregarding the corporate individuality for the purposes of the statute. Subsequently, *United States v. South Buffalo Railroad Company*<sup>91</sup> came up on substantially the same question, the holding company controlling both the producer and the railroad having "ostentatiously" observed the railroad's corporate formalities on the *Elgin* model. Pointing to reliance on *Elgin*, the court declined to hold there was a violation, observing that they might not approve the scheme if writing on a new slate.<sup>92</sup>

While the *Elgin* and *South Buffalo* cases are distinguishable from contract cases on the ground that they are statutory interpretations, and while their authority is somewhat dulled by the doubts of the

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<sup>86</sup> Compare cases cited notes 2, 7 and 10 *supra*, with cases cited notes 9 and 24 *supra*.

<sup>87</sup> Cf. *Charlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948).

<sup>88</sup> See cases cited notes 2, 7 and 10 *supra*.

<sup>89</sup> 298 U.S. 492 (1935).

<sup>90</sup> Stone, Brandeis and Cardozo, J.J., dissented.

<sup>91</sup> 333 U.S. 771 (1948).

<sup>92</sup> *Id.* Black, Douglas and Murphy, J.J., joined Rutledge, J., in a vigorous dissent.

*South Buffalo* majority and the vigor of the dissents, they remain a potential trap for the unwary. No contract precedent has been found denying relief when the formalities are observed but a legal fraud or wrong is shown. Since the factor of control seems to be the only common condition to relief, it might in itself be sufficient when there is a wrong.<sup>93</sup>

C. *The Injury, Injustice, or Inequity to Plaintiff*

The third condition to relief against a shareholder or affiliate is said to be a showing that there will be an injury, or unjust or inequitable result, if plaintiff is not afforded a remedy in disregard of the corporate entity.<sup>94</sup> As discussed above, this third element of liability is occasionally included within the second, the fraud or wrong of the defendant.<sup>95</sup> Separate conceptualization perhaps facilitates understanding and reflects the equitable nature and origin of relief against a shareholder or affiliate for a corporate obligation, but it does not seem to produce a different outcome.<sup>96</sup>

The foregoing classification of defendant's legal fraud or wrong presumed injury. However, some cases are better understood when the injury is observed as a separate requirement. For example, in the cases involving "leasehold" corporations, where relief against the shareholder or affiliate clearly causing the corporation to default is denied in the absence of a misrepresentation, it may be easier to explain the rather harsh result by classifying the injury as a separate element.<sup>97</sup> Thus it may be said that disregarding the corporate entity is an extraordinary device not warranted when the plaintiff knew of the instrumentality relation between his lessee and the defendant, and he is not legally injured when the defendant chooses to avail himself of what is in effect an option to default. When a deliberate default manipulated by the defendant is said to constitute no wrong under the two element analysis, it fails to account for plaintiff's notice of such possibility and his assumption of the risk of such default.

There is also an unresolved question of whether the solvency of the corporation precludes recovery from a shareholder or affiliate because the plaintiff has an adequate remedy against the corporate obligor. It does not appear that this issue is ever litigated, possibly due to the insolvency or near insolvency of the obligor corporation in nearly every case where a remedy is sought against a shareholder or affiliate on a

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<sup>93</sup> Cf. cases cited notes 2 and 7 *supra*.

<sup>94</sup> Powell ch. IV.

<sup>95</sup> *Id.* § 14.

<sup>96</sup> See note 56 *supra*.

<sup>97</sup> See cases cited note 65 *supra*.

contract claim.<sup>98</sup> It would seem that plaintiffs do not hazard a corporate entity action if there is any other remedy open to them.

### III. ALTERNATE THEORIES

In addition to disregarding the corporate entity, several other theories of action are frequently advocated in creditor suits against shareholders or affiliates. These theories are often confused with the problem of disregarding the corporate entity, but they differ greatly by imposing liability on the defendant as a principal rather than in its capacity as a shareholder or affiliate which is not a principal.

#### A. Agency

Agency is frequently referred to in cases involving claims against shareholders or affiliates, but usually in a non-technical sense as a synonym for terms such as "adjunct" or "instrumentality".<sup>99</sup> Occasionally however, an attempt to introduce technical agency rules into the problem of disregarding the corporate entity is made with the result that agency and improper control relationships are confused.

If it can be shown that the consensus necessary for an express or implied in fact agency relationship was present and that the corporation was legally the agent of its shareholder or parent, or affiliate, then there is no utility in disregarding the corporate entity because the shareholder or parent, or affiliate is liable at the plaintiff's election as a principal independent of any fraud or wrongful conduct, and independent of disclosure or nondisclosure of the agency relationship.<sup>100</sup> There is no legal objection to a technical agency relationship between a corporation and a shareholder or affiliate since both are legal entities free to contract, but it might be anticipated that such relationships would be rare because the very reason for incorporation is usually the avoidance or limitation of liability as a principal.

It cannot be maintained that stock ownership or control creates a technical agency relationship between the owner, as principal, and the corporate entity, as agent, since statutory or common law immunity embodied in the limited liability principle refutes agency despite the resemblance.<sup>101</sup> To attempt to analyse the contract cases in terms of an agency relationship implied in law, which is to say that none is required upon a proper showing of wrong, would do no more than restate

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<sup>98</sup> See Powell § 17.

<sup>99</sup> *New York Trust Co. v. Carpenter*, 250 F. 668 (6th Cir. 1918) (third *Carpenter* case). See Powell § 21.

<sup>100</sup> *Cf. Luckenbach S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.), *cert. denied*, 254 U.S. 644 (1920). See generally Powell § 22.

<sup>101</sup> Powell § 23.

the present rules while perverting the principles of agency which impose liability on a principal without fraud or wrong.<sup>102</sup> More objectionable is analysis in terms of agency relationships implied in fact which requires attributing an agency relation to permissible control functions. Such an approach is inconsistent with the protection supposedly afforded by incorporation.<sup>103</sup>

Technical agency rules are simply not applicable when it is sought to disregard the corporate entity for the purpose of a contract claim against a shareholder or affiliate. Where the term "agency" is not used by claimants and courts in its non-technical sense, it appears that the claimant was in doubt of his ability to establish a technical agency relationship and had brought suit on both agency and wrongful control grounds, often getting relief without any distinction between logically inconsistent grounds being made.<sup>104</sup>

### B. *Identity and Enterprise Entity*

The theory of identity<sup>105</sup> and the theory of enterprise entity<sup>106</sup> are not identical, but they have the same effect when applied to the contract cases. Both result in the conceptualization of the obligor corporation and the shareholder or affiliate as *one* for the purpose of affording a remedy against the shareholder or affiliate.

All would concede that at some point a corporation must cease to exist under the state statutory scheme. Its formal corporate structure may be so deteriorated that it is absurd to maintain that there is yet a corporation. Clearly, when this point is reached the shareholder is not doing business as a corporation, but as an individual, and there is little resistance to his individual liability.<sup>107</sup> When the deterioration is less unequivocal there may still be such an interrelation of affairs that the conclusion is irresistible that there is a "oneness" in what are not clearly separate entities, and courts may treat the enterprise as individual for the purpose of imposing liability without emphasizing the fraud or wrong necessary to relief against a shareholder.<sup>108</sup>

Whatever its worth in cases not involving limited liability,<sup>109</sup> the

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<sup>102</sup> See authorities cited note 99 *supra*.

<sup>103</sup> Powell § 22. See *New York Trust Co. v. Carpenter*, 250 F. 668 (6th Cir. 1918).

<sup>104</sup> See *Luckenback S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir. 1920); *Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 105 P.2d 649 (1940).

<sup>105</sup> See Powell § 24.

<sup>106</sup> See Latty 213-19.

<sup>107</sup> See *Automotriz del Golfo de California S.A. de C. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957); *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957). Cf. *Codomo v. Emmanuel*, 91 So. 2d 653 (Fla. 1956).

<sup>108</sup> See cases cited note 107 *supra*.

<sup>109</sup> See, e.g., *U.S. Grain Corp. v. Phillips*, 261 U.S. 106 (1923); *United States v.*

concept of identity has doubtful validity in the contract cases where incorporation for the very purpose of distinctiveness as an obligor is permissible.<sup>110</sup> Where the obligor corporation is clearly in existence, and limited liability is a permissible objective, there seems to be little utility in finding an identity of interest, which, without a showing of legal fraud or wrong, is not a proper basis for relief.<sup>111</sup>

It has been suggested that the entire economic unit of which the corporate units are parts be considered the entity liable to creditors of the corporate units.<sup>112</sup> While this theory of enterprise entity no doubt has great merit as a basis for economic decisions like extending credit to a parent corporation or a holding company, or entering upon a new business venture, or for the governmental decisions involved in the regulation of business or taxation,<sup>113</sup> it is inherently antithetical to the principle of limited liability and the policy behind it which permits an allocation of risks by separate incorporation of subsidiaries.<sup>114</sup> It is further to be noted that economists themselves do not agree on what constitutes a single business entity, and there is a problem of whether an entity is the same for all purposes.<sup>115</sup> At least in the contract cases, the theory of enterprise entity seems to have limited justification although the economic realities of intercorporate relationships need not and are not ignored by the courts.<sup>116</sup>

If the creditor cannot show that the shareholder or affiliate is a principal to the credit transaction, he cannot recover on agency, identity, or enterprise entity theories. He must then rely on the theory of disregarding the corporate entity and prove its three elements—the instrumentality, the wrong, and the injury. The deficiencies of the first element, the instrumentality rule, have been discussed, and it is sug-

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Walter, 263 U.S. 15 (1923). Of these two cases Mr. Justice Holmes reportedly said: "Twice lately I have had to guard against the corporate fiction becoming a non-conductor in the wrong place." Wormser, "Disregarding of the Corporate Fiction—When and Why," 23 Colum. L. Rev. 702 (1923).

<sup>110</sup> Cf. *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

<sup>111</sup> See cases cited notes 9 and 24 *supra*. See generally Fletcher §§ 41-48; Powell § 12. But see *Luckenback S.S. Co. v. W. R. Grace & Co.*, 267 F. 676 (4th Cir.) (*semble*), *cert. denied*, 254 U.S. 644 (1920) (alternate grounds of agency and identity).

<sup>112</sup> Latty 213-19.

<sup>113</sup> *Accord*, *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949).

<sup>114</sup> See *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955); *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, *cert. denied*, 300 U.S. 655 (1936); *Ohio Edison Co. v. Warner Coal Co.*, 79 Ohio App. 437, 72 N.E.2d 207 (1946).

<sup>115</sup> Latty 213-19.

<sup>116</sup> *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937) (supervening illegality affects lawful contract utility rate charged by subsidiary). See *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962).



gested that the rule should be rejected and replaced by a requirement of showing a control relationship between the defendant and the corporation. This showing should support an inference that such control enabled defendant to use the corporation to effect the legal fraud or wrong that caused plaintiff's injury.

#### IV. THE INSTRUMENTALITY RULE SHOULD BE REJECTED IN CONTRACT CASES

The vice of the instrumentality rule is that it is not well related to the results in contract cases. Dominance by the defendant of the affairs of the obligor corporation appears to be present in all of the cases where a creditor seeks to avoid corporate limitations of liability.<sup>117</sup> Defendant's intermeddling and disregard of corporate formalities such as directors meetings and separate record keeping are frequently shown, but it is difficult to see how these matters could harm the creditor.<sup>118</sup> The economic benefit defendant derived or intended to derive from the corporation is described in the opinions in cases where relief is granted, but it clearly exists in cases where relief is denied.<sup>119</sup> While there may be a correlation between these factors and relief, it is certainly indirect and seems to be unduly amplified by the emphasis in court opinions.

While the origins of the rule may be traced to dicta,<sup>120</sup> there are perhaps two reasons for its apparent currency. First, creditors will conform their suits to precedent and may be expected to marshal evidence of defendant's dominance, intermeddling, and benefit when they feel there is basis for a claim against a shareholder or affiliate. Such evidence will not be ignored by courts bound by precedent, and perhaps not greatly concerned with this complex doctrine which is infrequently invoked, but will be seized upon or explained away by opinion. Second, there is frequently a direct relation between these factors and the legal fraud or wrong of the defendant. Their presence often supports the inference of wrongful conduct by showing the balance of a scheme to defraud the creditor.<sup>121</sup>

To state the rule as a condition to relief, however, produces false issues. It is nonsense to argue that defendant's dominance, intermeddling, and contemplated benefit in its relation to the corporation are wrong. They are neither lawful nor wrongful for the purpose of relief

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<sup>117</sup> See cases cited notes 2, 7, 9, 10 and 24 *supra*.

<sup>118</sup> See cases cited note 34 *supra*.

<sup>119</sup> *E.g.*, *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

<sup>120</sup> See note 19 *supra*.

<sup>121</sup> See cases cited note 34 *supra*.

against a shareholder or affiliate; what is a basis for relief is the fraudulent or deceitful conduct of the defendant. If the defendant has used the device of incorporation to deceive and defraud the plaintiff, its separate legal personality will afford him no protection.<sup>122</sup> In the contract cases, the typical defendant has a right to rely on the limited liability principle and shift some of the risk of the enterprise to creditors.<sup>123</sup> Unless he has somehow misled a creditor or acted subsequent to the creditor's trust in a manner inconsistent with the creditor's reasonable understanding and expectation, he should not incur liability and he does not in the cases.<sup>124</sup> The control factor is apparently the only one under the rule necessary to relief, probably because control is the only nexus with the corporation which will support the inference that defendant caused plaintiff's loss.<sup>125</sup> Control itself is not logically indispensable but is perhaps dictated by the economic realities of most cases. An affiliated corporation, however, which does not control but is controlled may be held responsible.<sup>126</sup> Since the other factors under the rule are not necessary, the validity of the rule is doubtful.

The effect of the instrumentality rule is to confuse lawful business organization with schemes to defraud creditors by obscuring the distinction between defendant's conduct toward the obligor corporation and defendant's conduct toward the plaintiff. Under the rule, factors coming from and supporting an inference of fraudulent or wrongful conduct have been given the gloss of fraudulent or wrongful conduct themselves. Epithet is used to distinguish those present when liability is to be imposed on a shareholder or affiliate. Thus it cannot be determined that the defendant has used the corporation as a mere instrumentality, adjunct, or alter ego until it has been concluded that defendant is liable for the corporate obligation. Even though there may be a relation between the factors recited under the instrumentality rule and defendant's legal fraud or wrong, the utility of the rule is severely limited when it does not serve to enable prediction of liability.

## V. A SUGGESTED ANALYSIS

### A. *The Purpose for Disregarding the Corporate Entity in Each Case*

The purpose for which it is sought to obtain relief in disregard of an asserted corporate entity barrier should limit and control the relevant factors in defendant's relationships with the corporation and the plain-

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<sup>122</sup> Compare cases cited note 81 *supra* with cases cited note 34 *supra*.

<sup>123</sup> See cases cited note 81 *supra*.

<sup>124</sup> See cases cited note 81 *supra*.

<sup>125</sup> Powell § 6(a).

<sup>126</sup> See authorities cited note 38 *supra*.

tiff.<sup>127</sup> The reasons for disregarding the corporate entity to provide a remedy for a personal injury for plaintiff are different than the reasons for granting a contract claimant relief against a shareholder or affiliate.<sup>128</sup> Still different reasons prevail in cases where the questions are the violation of a statute,<sup>129</sup> the application of internal revenue laws,<sup>130</sup> or the law of fiduciary obligations.<sup>131</sup> In such cases the limited liability principle is not in issue.

In the contract cases the principle of limited liability is directly challenged. Incorporation for the very purpose of limiting liability is permissible,<sup>132</sup> and the contract claimant is not given a remedy against a shareholder or affiliate in the absence of a misrepresentation, fraudulent management, or illegality of a kind inconsistent with his reasonable knowledge and expectation at the time he trusted the credit of the corporation.<sup>133</sup> An attempt to reconcile the contract cases with cases not involving consensual credit transactions by comparison of the defendant's conduct toward the corporation is fruitless: there is no more than a sometimes similarity.<sup>134</sup>

B. *The Reason for Liability: Legal Fraud or Wrong  
in Contract Cases*

Emphasis should be placed on the particular kinds of legal fraud or wrong that support liability of a shareholder or affiliate for corporate contractual obligations. The courts invariably require a showing of defendant's fraud or wrong as a condition to a remedy in disregard of an apparent entity barrier,<sup>135</sup> but particularity as to the conduct of the defendant which distinguishes cases in which relief is granted from those in which it is withheld is not demanded. The result is that conduct

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<sup>127</sup> *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937).

<sup>128</sup> Compare *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962), with *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

<sup>129</sup> See, e.g., *United States v. Milwaukee Refrigerator Transit Corp.*, 142 F. 247 (E.D. Wis. 1905).

<sup>130</sup> See, e.g., *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945).

<sup>131</sup> See, e.g., *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 222 N.Y.S. 883 (Sup. Ct. 1927).

<sup>132</sup> Accord, cases cited note 24 *supra*.

<sup>133</sup> See cases cited note 81 *supra*.

<sup>134</sup> In *North v. Higbee Co.*, 131 Ohio St. 507, 3 N.E.2d 391, cert. denied, 300 U.S. 655 (1936), the majority relied on contract cases to hold a parent corporation not liable for default on a lease by its subsidiary leasehold corporation while the dissent cited principally noncontract cases.

<sup>135</sup> See authorities cited note 53 *supra*.

producing liability is obscurely reported and difficult to detect in many opinions where a shareholder or affiliate is held liable.<sup>136</sup>

Perhaps the failure to clearly state the grounds for granting or denying recovery is due to the emphasis given the instrumentality rule, or perhaps it stems from the difficulty in articulating reasons for a judicial feeling that the corporate entity has been interposed as a shield against liability in the wrong place.<sup>137</sup> Whatever the reason, distinct classes of defendant's fraud or wrong can be found in the contract cases granting relief, and the presence of one of these particular wrongs is directly related to a remedy against a shareholder or affiliate.

The kinds of fraud or wrong which support relief in contract cases are misrepresentations before plaintiff became a creditor,<sup>138</sup> defendant's conduct inconsistent with plaintiff's reasonable expectation as a creditor subsequent to the establishment of the credit relationship,<sup>139</sup> and supervening illegality which is not properly defendant's wrong, but a determination of public policy which limits defendant's conduct and benefits a class including plaintiff.<sup>140</sup> The kinds of misrepresentation supporting relief are those inconsistent with plaintiff's reasonable understanding that he was trusting only the credit of a corporation. The shareholder or affiliate will be liable for corporate obligations when it suppresses the fact of incorporation,<sup>141</sup> when it leads the creditor to believe that it guarantees the corporate obligation,<sup>142</sup> or when it creates a false appearance which causes a reasonable creditor to misapprehend the worth of the corporate obligor.<sup>143</sup>

Inadequate capitalization has been treated as a basis for the liability of a shareholder or affiliate,<sup>144</sup> but its effect in the contract cases is doubtful. While the failure to provide an adequate capital fund from which injured members of the public may obtain redress may be wrong-

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<sup>136</sup> *E.g.*, cases cited note 34 *supra*.

<sup>137</sup> *See* note 109 *supra*.

<sup>138</sup> *See, e.g.*, *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942).

<sup>139</sup> *See, e.g.*, *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951).

<sup>140</sup> *See* *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 288, 107 S.W.2d 41 (1937).

<sup>141</sup> *See* *Shafford v. Otto Sales Co.*, 149 Cal. App. 2d 428, 308 P.2d 428 (1957). It is apparent that the duty to disclose is controlled by the creditor's reasonable understanding that he is dealing with a corporation when his contact is with the individual shareholder defendant. Where the fact of incorporation is obvious, the point is not raised.

<sup>142</sup> *See* *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942).

<sup>143</sup> *See* *Portsmouth Cotton Oil Refining Corp. v. Fourth Nat'l Bank*, 280 F. 879 (M.D. Ala.), *aff'd*, 284 F. 718 (5th Cir. 1922).

<sup>144</sup> *See* *Mull v. Colt Co.*, 31 F.R.D. 154 (S.D.N.Y. 1962).

ful when a corporate enterprise creates a substantial public hazard,<sup>145</sup> there is no sound reason for limiting the allocation of risk between a consensual creditor and a shareholder or affiliate which openly limits its liability by incorporation. Although inadequate capitalization is frequently discussed in the contract cases, it has been distinguished from the kinds of fraud or wrong which support relief.<sup>146</sup> It should not be treated as a factor directly supporting relief against a shareholder or affiliate, or even indirectly supporting relief if the plaintiff understood that he was dealing with a corporation nominally or inadequately capitalized.

Irrespective of the adequacy of capitalization and defendant's dominance, intermeddling, or benefit, the principle of limited liability has been given effect in contract cases when plaintiff's reasonable understanding of the allocation of risk has not been increased by defendant's antecedent or subsequent conduct.<sup>147</sup> The one exception is where an external factor, for example legislation, changes the quality of defendant's conduct which was lawful under the contract to wrongful under the law. Emphasis on the particular legal fraud or wrong of the defendant is necessary to understand the process of disregarding the corporate entity for contract claims.

### C. *The Effect of Disregarding the Corporate Entity on the Principle of Limited Liability*

Relief against a shareholder or affiliate for a corporate obligation should never be considered independent of its effect on the limited liability principle. It is clear that the limitation of liability is a permissible reason for incorporation,<sup>148</sup> and the shareholder or affiliate expectation that it will not be individually liable for the corporation's obligations is not lightly dismissed by the courts however inarticulately stated the policy supporting limited liability may be.<sup>149</sup>

In cases not involving consensual creditor's claims, where the limited liability principle is not directly challenged, courts have more readily ignored the separate existence of a corporate entity because the corporate entity barrier has frequently been asserted for impermissible

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<sup>145</sup> *Id.*

<sup>146</sup> *Charlesmo v. Schwebel*, 87 Cal. App. 2d 482, 197 P.2d 167 (1948). *Accord*, *Hanson v. Bradley*, 298 Mass. 371, 10 N.E.2d 259 (1937).

<sup>147</sup> See cases cited note 81 *supra*.

<sup>148</sup> *E.g.*, *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

<sup>149</sup> See *Bartle v. Home Owners Co-operative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

purposes.<sup>150</sup> In the contract cases, however, limited liability will usually be sustained and the corporate entity will not be disregarded in the absence of a showing that the shareholder or affiliate has engaged in conduct that is legally fraudulent or wrongful because it is inconsistent with the consensual limitation of liability.<sup>151</sup>

## VI. CONCLUSION

A contract claimant seeking to hold a shareholder or parent corporation, or an affiliated corporation, for an obligation of the corporation is faced with the principle of limited liability which is a permissible objective of incorporation. Courts will not lightly disregard the separate corporate existence of the obligor, but when the defendant has suppressed the fact of incorporation, when it has implied a guarantee of the obligation, when it has misled the plaintiff by creating an appearance of wealth which was reasonably relied upon, when it has managed the corporation in a manner inconsistent with the plaintiff's reasonable expectation, or when supervening illegality has made the defendant's management of the corporation wrongful as to plaintiff, the distinct corporate personality of the obligor has not been accepted as a defense.

Emphasis on the so-called instrumentality rule tends to confuse the relevant factors supporting relief in disregard of an apparent corporate entity barrier. The defendant's dominance, intermeddling, and benefit in its relationship to the corporation are discussed at length in court opinions, but these factors do not serve to distinguish cases where relief is granted from those in which it is withheld. Such factors may, however, have some evidentiary value in supporting inferences of defendant's legal fraud or wrong. Inadequate capitalization is frequently treated as a factor supporting relief, but its effect is doubtful in the contract cases where no public policy limits the allocation of risks in consensual credit transactions. If an agency relationship exists between the defendant and the corporation, relief need not depend on the extraordinary device of disregarding the corporate entity. If the consensus necessary to recover on ordinary agency principles can be found, the defendant is liable as a principal irrespective of fraud or wrong. If the defendant shareholder or affiliate is not a principal, the agency model serves only to confuse. Theories of identity and enterprise may have merit in taxation or business regulation, but they are poor bases for shareholder or affiliate liability because they are antithetical to the

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<sup>150</sup> See cases cited note 2 *supra*.

<sup>151</sup> See cases cited note 81 *supra*.

limited liability principle which is of paramount importance in the contract cases.

The contract claim presents a unique question of the limitation of liability. Tort claims, arising from non-consensual transactions, present different questions due to public policy limitations on the allocation of risks between enterprise and the public. In other kinds of cases, taxation and statutory interpretation, for example, the questions involved do not touch limited liability. The purpose for which the corporate entity is to be disregarded should limit and control the relevant factors supporting the remedy. In the contract cases the limited liability principle precludes recovery from a shareholder or parent corporation, or an affiliated corporation, in the absence of a showing that the defendant's conduct was inconsistent with plaintiff's reasonable understanding that he could look only to the corporation to satisfy his claim.

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